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Wilshire Private Markets

ACTIVE vs. PASSIVE MANAGEMENT

Thomas Toth, CFA, Managing Director
Ali Kazemi, Managing Director

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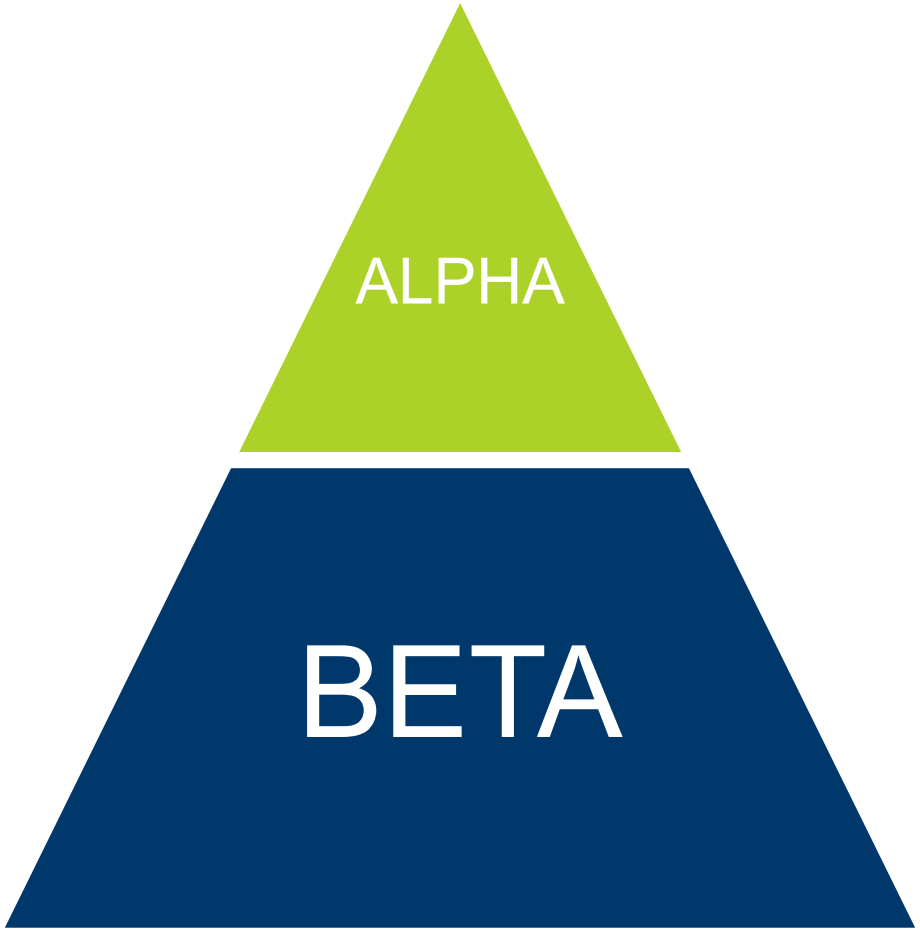
ACTIVE VS. PASSIVE 1.0



ALPHA measures the idiosyncratic return relative to a market after adjusting for Beta

- Complements Beta (should be uncorrelated)
- Less stable than Beta
- More expensive

BETA measures the systematic exposure of an asset or portfolio relative to the market

- Asset allocation process remains the most important investment decision
- More stable
- Inexpensive

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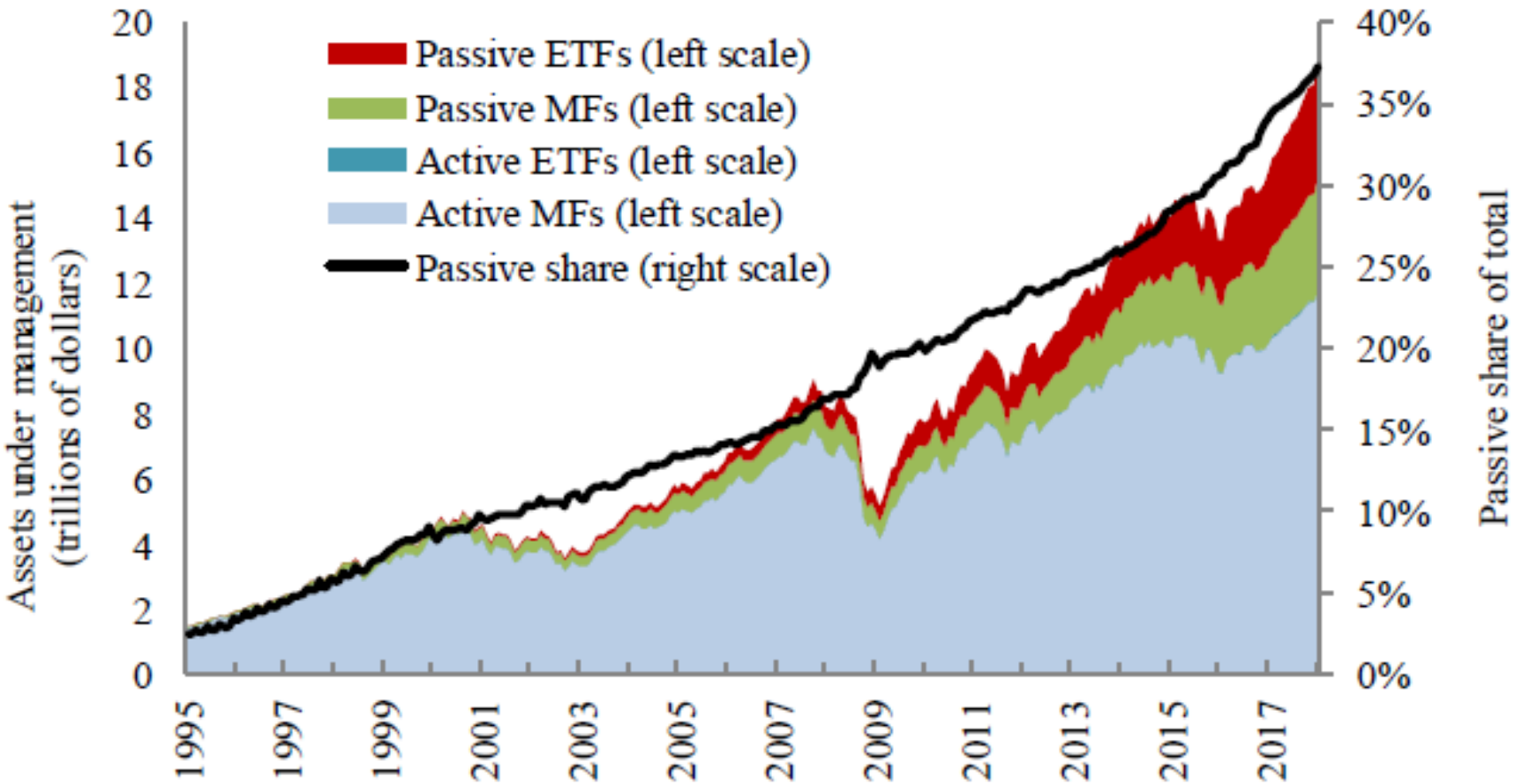
GROWTH IN PASSIVE SHARE



Source: Morningstar

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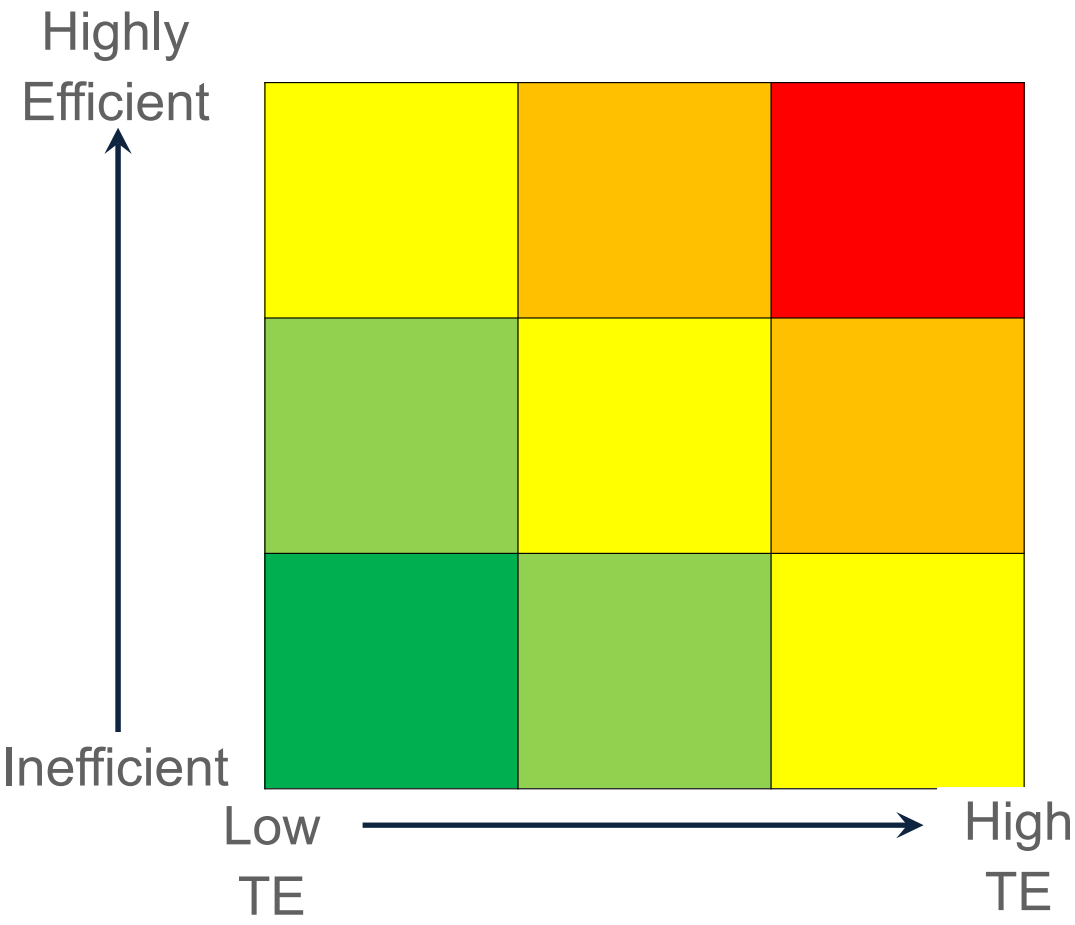
LIKELY SUCCESS OF ACTIVE MANAGEMENT

Success of active management, measured by **information ratio** (excess return over excess risk), is generally higher in less-efficient markets and in low excess risk (tracking error) strategies

Information ratios tend to fall as:

- Investment shifts towards highly efficient markets
- Investment shifts towards high tracking error strategies



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MARKET EFFICIENCY

INVESTMENT CATEGORY	MARKET OBSERVATIONS
EQUITY	
U.S. Large Cap	Highly Efficient
U.S. Small Cap	Moderately Efficient
Non U.S. Developed Markets	Moderately Efficient
Non U.S. Emerging Markets	Inefficient
FIXED INCOME	
Core Bonds	Moderately Efficient
High Yield	Inefficient – ***But it's been tough!!***
ALTERNATIVE	
Commodities	Inefficient
Public Real Estate	Moderately Efficient
Private Real Estate	Active Only
Private Equity	Active Only
Hedge Funds	Inefficient

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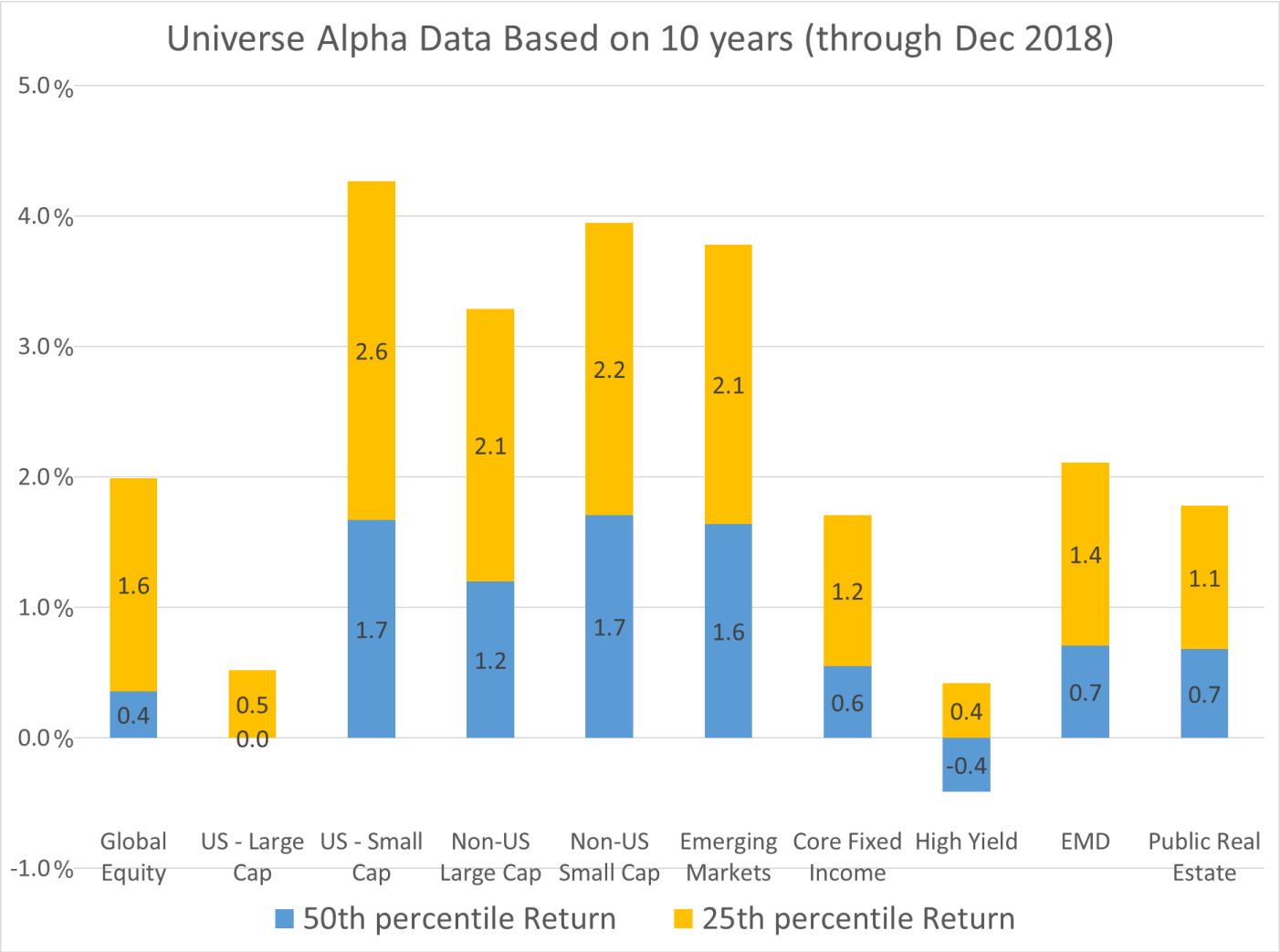
ALPHA



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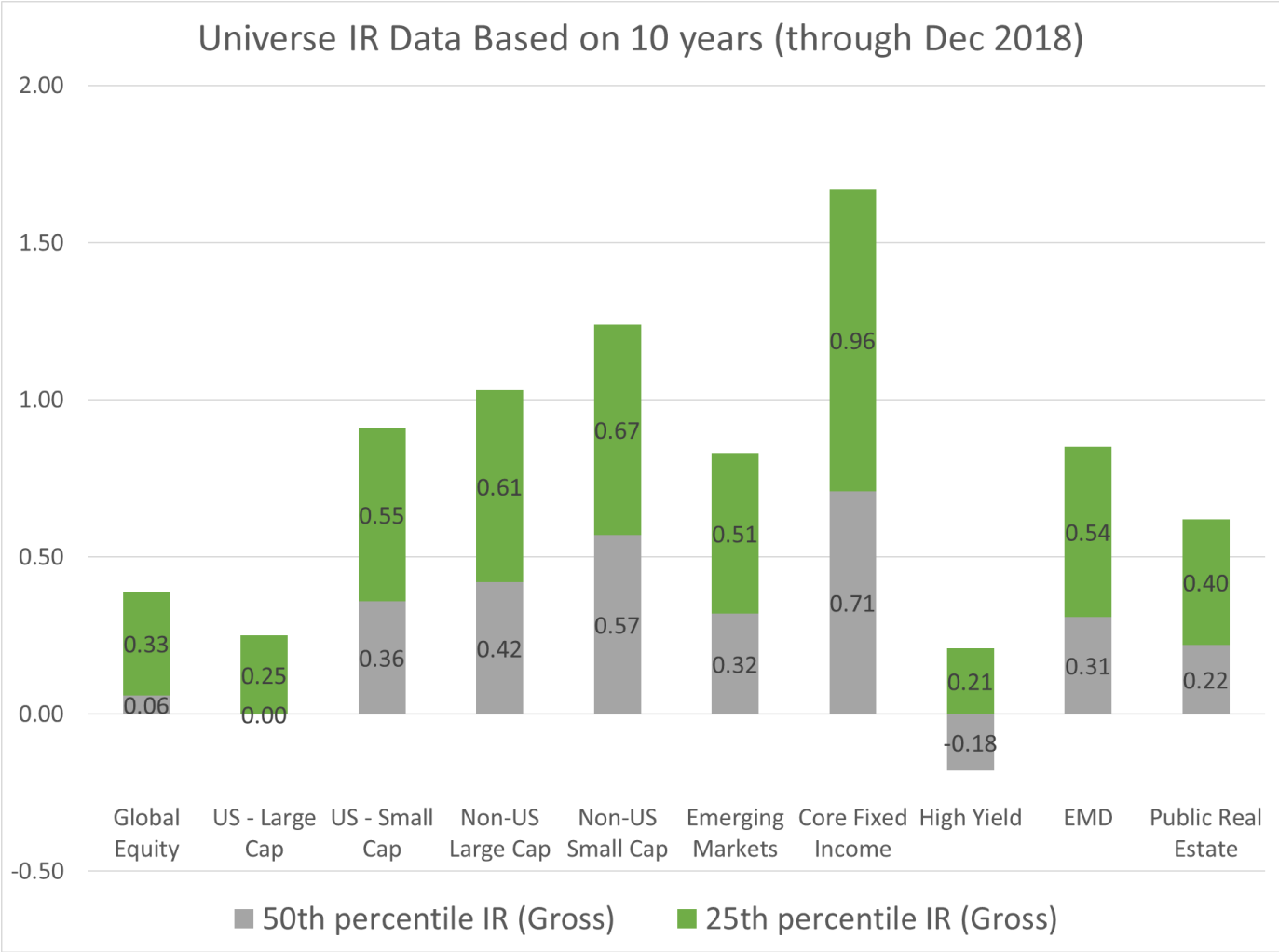
INFORMATION RATIO



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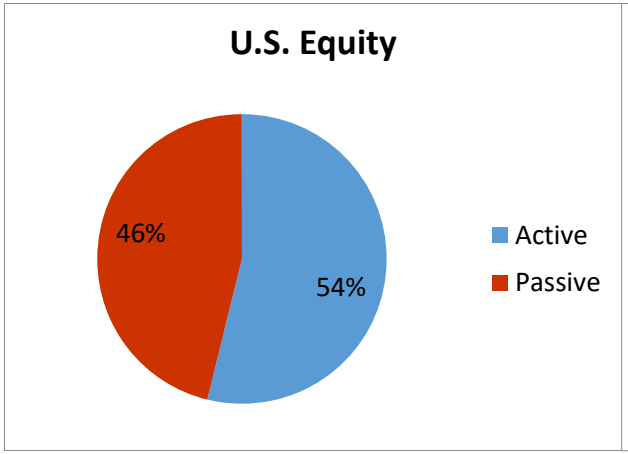
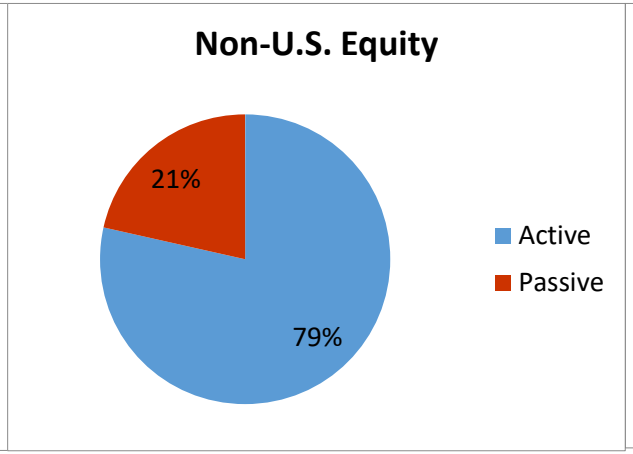
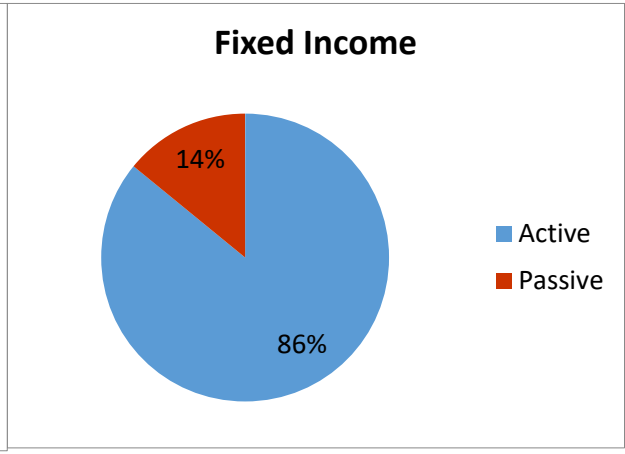
ACTIVE VS. PASSIVE MANAGEMENT

Implementation by U.S. Institutional Investors







Conclusions:

Most Investors have a mix of active AND passive strategies

Source: Greenwich Associates Market Trends Report (2017)

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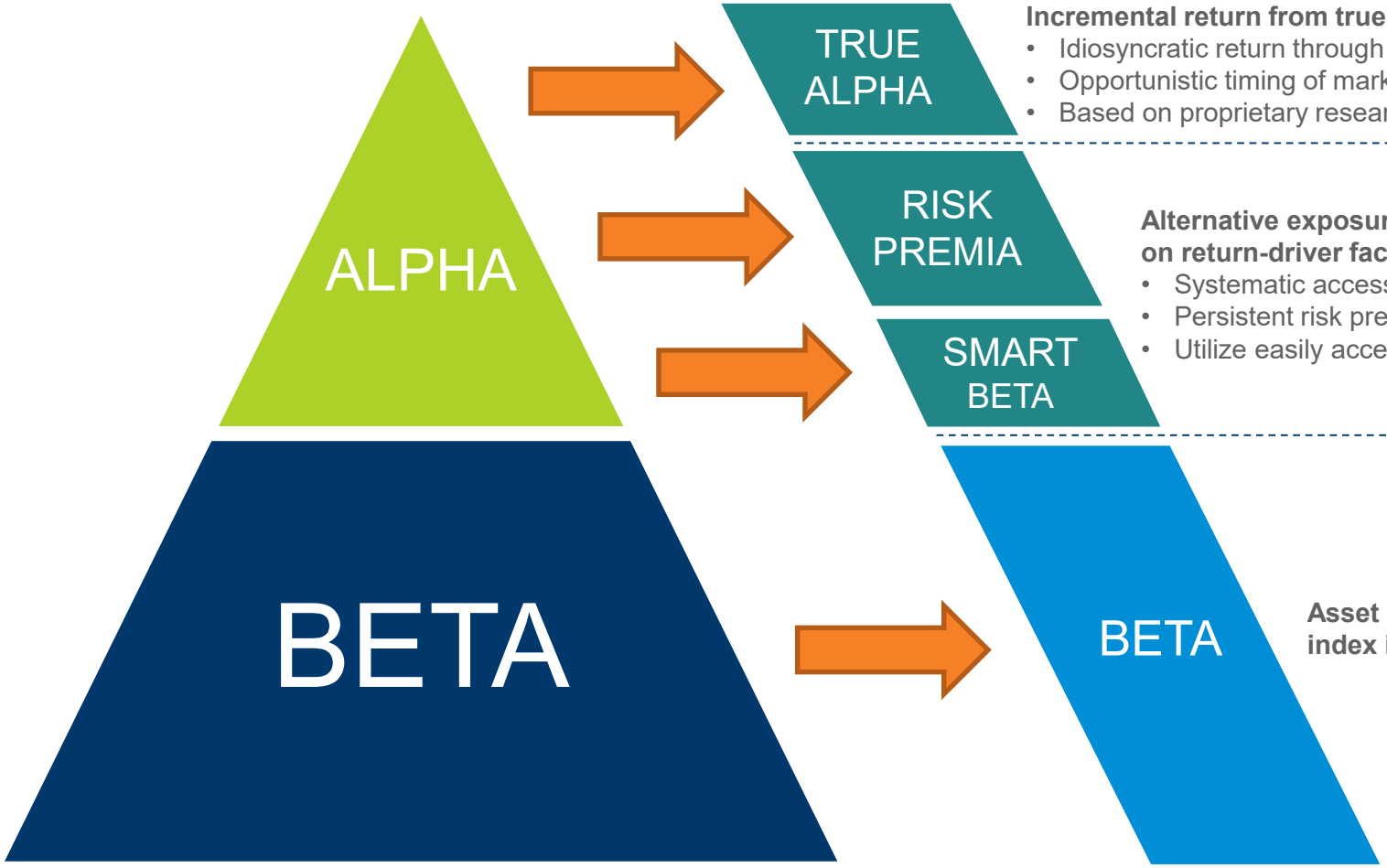
ACTIVE VS. PASSIVE 2.0



Incremental return from true active management
- Idiosyncratic return through security selection
- Opportunistic timing of market dislocation
- Based on proprietary research, models, insight

Alternative exposure to asset class based on return-driver factors
- Systematic access to desired factors
- Persistent risk premium over long-term
- Utilize easily accessible public data

Asset class return / Passive index investment return

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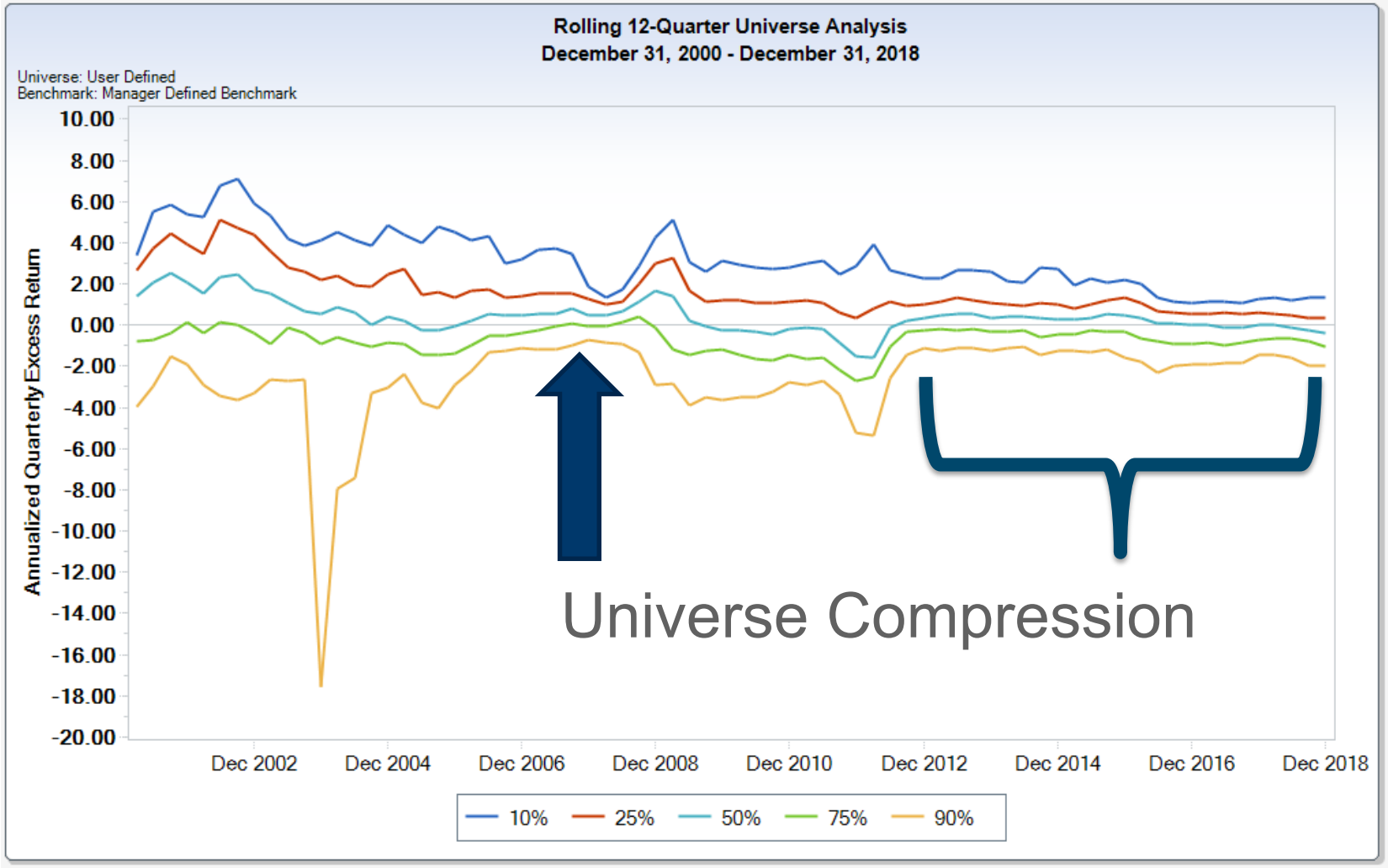
EXAMPLE: WHAT'S UP (OR DOWN) WITH HY?



Source: Wilshire Compass

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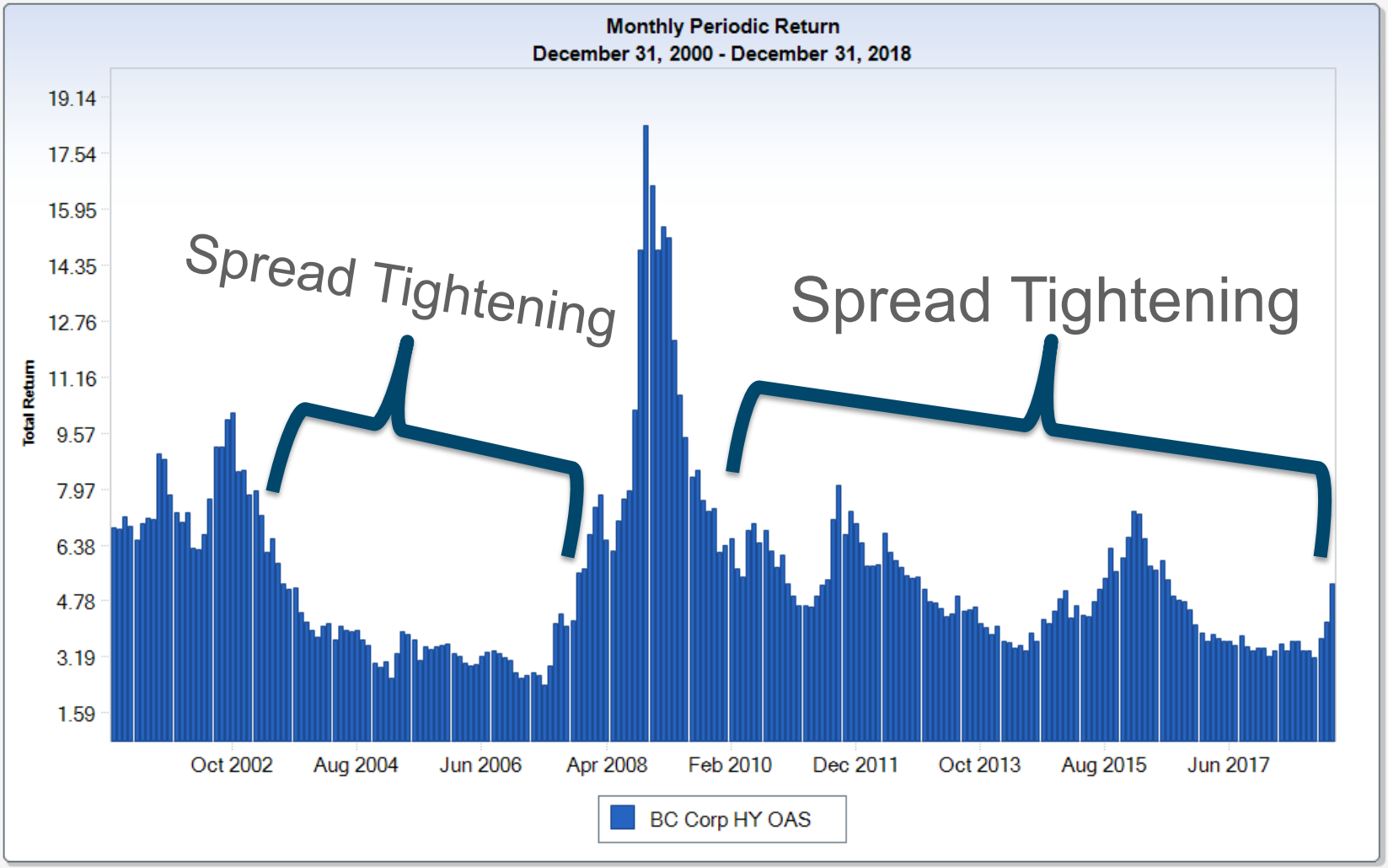
EXAMPLE: SECULAR SPREAD ENVIRONMENT



Source: Wilshire Compass

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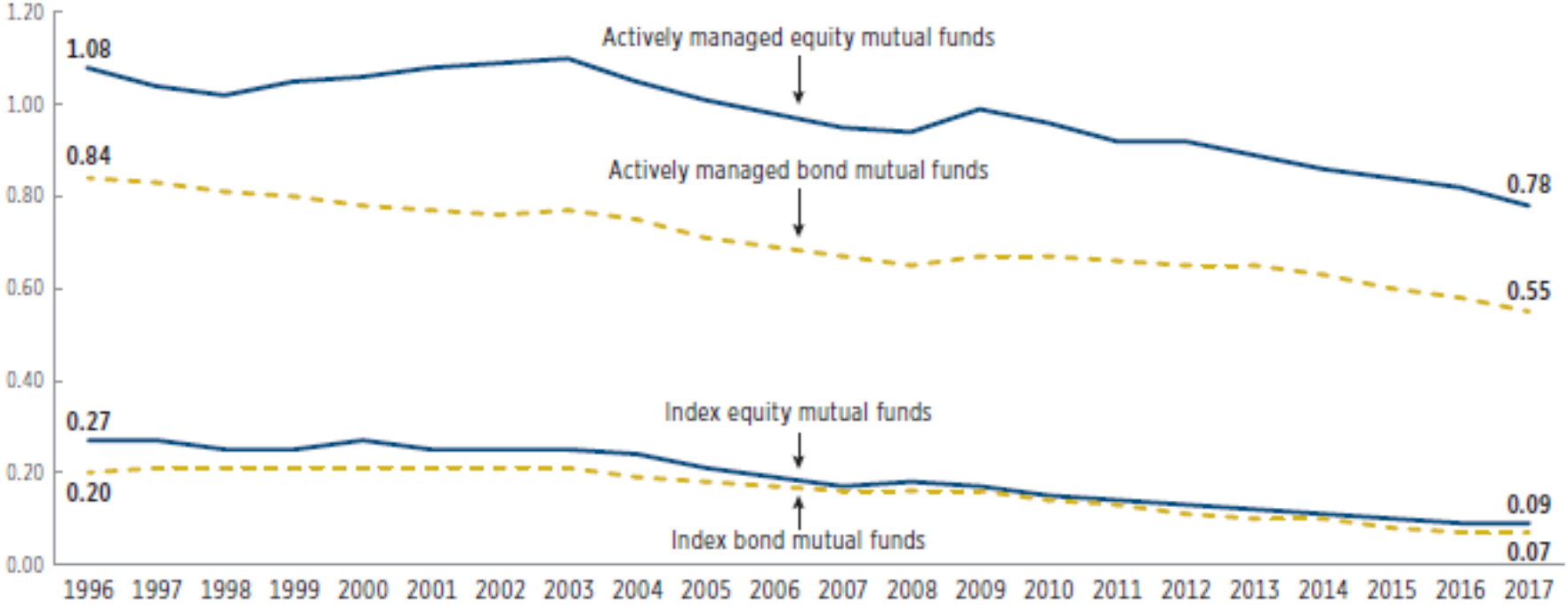
FEE COMPRESSION

- Declining fees for investment management, with trends likely to continue
- Rise of smart beta/factor products
- Growing prevalence of incentive fees?



Expense ratios of actively managed and index mutual funds
Percent, 1996 – 2017

Source: Investment Company Institute – "Trends in the Expenses and Fees of Funds, 2017"

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ASSET MANAGER CONCENTRATION

- Economics of scale
- Minimal differentiation among index fund providers
- Risk of significant idiosyncratic event at a very large firm (e.g. cyber security breach)
- "Too Big To Fail"; systemically important financial institutions?

	Overall Market Share (%)*		Passive Fund AUM March 2018 ($bn)
	March 1999	March 2018	
Vanguard	11	23	3,404
BlackRock	0	8	1,410
State Street	0	3	613
Fidelity	14	9	422
Charles Schwab	0	1	174

*** Asset manager's market share for all (actively and passively) managed mutual funds and ETFs**

Source: Federal Reserve Board "The Shift from Active to Passive Investing: Potential Risks to Financial Stability?" (2018)

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IMPACTS ON FINANCIAL STABILITY

Risk Type	Description	Impact of Active-Passive Shift on Financial Stability
Liquidity Transformation and Redemption	Funds redeem daily in cash regardless of portfolio liquidity; investor flows respond pro-cyclically to performance	Reduces
Investing Strategies that Amplify Volatility	Leveraged and inverse exchange-traded products require high-frequency momentum trades, even in the absence of flows	Increases
Asset Management Industry Concentration	Passive asset managers are more concentrated than active ones, so the shift to passive increases concentration	Increases
Changes in Asset Valuations, Volatility, and Co-movement	Index inclusion effects: assets added to indexes experience changes in returns and liquidity, including greater co-movement	Unclear

Source: Federal Reserve Board “The Shift from Active to Passive Investing: Potential Risks to Financial Stability?” (2018)

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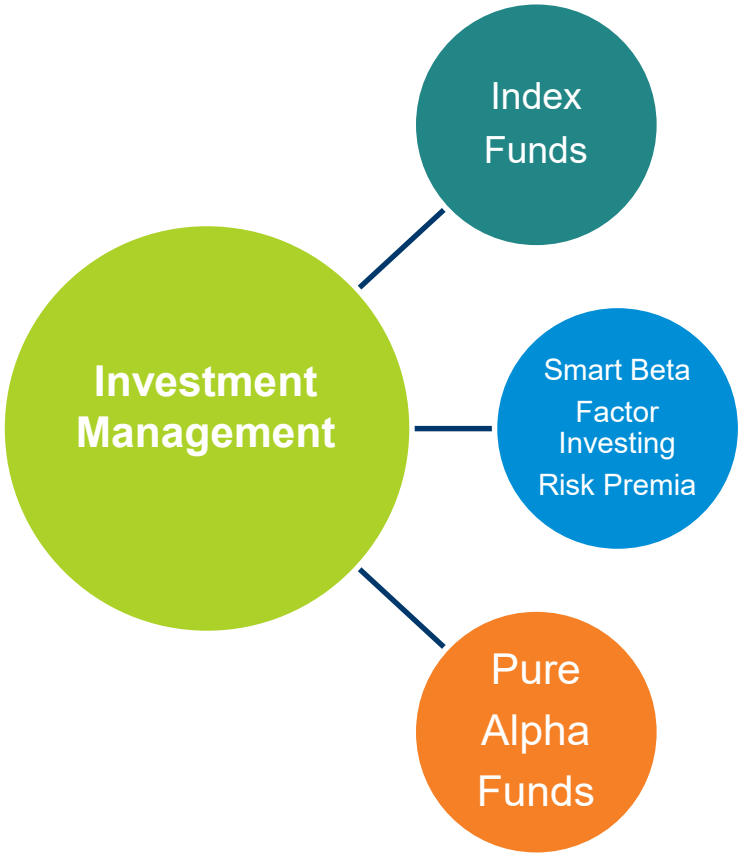
ACTIVE VS. PASSIVE 3.0

No longer a binary choice



- The future is likely to see three branches of investment management co-evolve alongside one another
- Each branch is supported by different structural tailwinds, and each faces its own set of challenges
- Technology will continue to play (an increasingly) central role, ushering forth both new products and tools for understanding capital markets
- Lower fees and increased transparency benefit all investors

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PUTTING IT ALL TOGETHER

Active vs. Passive 1.0: The debate is over

- Asset classes vary
- Most investors have a mix of active and passive

Active vs. Passive 2.0: It's all about risk management

- Alpha has been redefined
- Have a deeper understanding of the drivers of performance and risk

Active vs. Passive 3.0: More products, more technology, but more volatility?

- Passive products will continue to grow market share, increasing liquidity and transparency, and putting increased pressure on active management fees
- However, volatility and concentration could also increase (over the long-term)
- We've already moved from 2 to 3 categories – (Passive, Smart/Beta, Active) and new technology will continue to bring new products

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